

AGENDA ITEM 3b
AUDIT RESOLUTION STATUS-FINANCIAL STATEMENT AUDIT
MANAGEMENT LETTER COMMENTS - CURRENT YEAR REPORT
AS OF JUNE 30, 2010

Audit (Report Issue Date): Report to Management for the Year Ended 06/30/09 (11/19/09)

Observation 1: CERBTF Contributions and Distributions

Division responsible: Constituent Relations and Audit Services

Observation:

During our audit, we determined that premium payments made by participating employers outside of the CERBTF were not reported in the financial statements as required by generally accepted accounting principles (GAAP). The Governmental Accounting Standards Board recently provided clarification and guidance which requires the reporting of payments made outside of the trust as both contributions toward the annual required contribution and as distributions from the trust. For the fiscal year 2008-09, an audit adjustment of approximately \$228 million was recorded to reflect contributions and distributions made outside of the CERBTF as required by GAAP. Current policy allows employers to offset premium payments made outside of the trust against the employers' required contributions to the trust. The policy does not address how the employers should report those payments to the System. In fiscal year 2008-09, the CERBTF Compliance and Reporting Unit requested contribution and distribution information from all participating employers via email. However, responses were not received from all employers and the transactions originally were not reflected in the financial statements.

We recommend that CalPERS enhance policies and procedures to gather the contributions and distributions data from participating employers. In the limited instances in which the employers do not provide the requested data, CalPERS should develop a process to estimate premium payments made outside of the CERBTF. As part of the enhanced policy, CalPERS should consider requiring annual certification of the annual required contribution (ARC), premiums paid outside of the CERBTF and the net contribution made from all participating employers.

Fiscal Services should work with the Compliance and Reporting unit to record the transactions in the general ledger as they are reported to CalPERS by the employers. In addition, we recommend that the Office of Audit Services consider examining amounts reported by participating employers on a risk-based, periodic basis. The examination should be designed to determine that CERBTF disbursements reported by participating employers comply with the policies outlined in CalPERS' CERBTF Prefunding Plan.

Management's Response:

COMPLETE. Pending final verification by Macias Gini & O'Connell. The CERBTF Compliance and Reporting Unit has enhanced policies and procedures to collect contributions and distributions from participating employers and reviewed the process with the auditors. The Compliance and Reporting unit will obtain annual certification of ARC premiums paid outside of the CERBTF and net contributions made from all participating employers.

The CERBTF Compliance and Reporting Unit and the Office of Audit Services concur and have met to develop a risk based approach to examine on a periodic basis if CERBTF employers comply with CalPERS policies outlined in the CERBTF Prefunding Plan.

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Observation 2:	CERBTf Actuarial Valuations
Division responsible:	Audit Services
<p>Observation: Employers participating in the CERBTf engage third-party actuaries to perform other post-employment benefits (OPEB) valuations in accordance with the CalPERS <i>OPEB Assumption Model</i>. CalPERS actuaries review each valuation for compliance with the CalPERS OPEB Assumption Model; however, current procedures do not include an independent review of the underlying participant data used by the third-party actuaries. Errors in member data may distort valuation results and lead to improper determinations of actuarial accrued liabilities and annual required contributions.</p> <p>We recommend that the Office of Audit Services perform risk-based, periodic tests of participant data used by the third-party actuaries. The tests should be designed to determine that participant data used in the actuarial valuations is consistent with the participating employers' official records.</p> <p>Management's Response: IN PROGRESS. Office of Audit Services agrees with the recommendation, and has worked with Constituent Relations to develop procedures to review participant data used in OPEB valuations provided by employers who participate in the CERBTf. The procedures were completed as of June 30, 2010. A series of pilot reviews will start in late August 2010, with a target completion date of June 30, 2011.</p>	
Observation 3:	Claims Processing
Division responsible:	Health Benefits Branch
<p>Observation: CalPERS has contracted with third-party administrators to service the claims of its health plans and prescription drug program. Service agreements stipulate that claims must be submitted to the third-party administrators within 15 months and 12 months of the related service, for health plan claims and prescription drug claims, respectively. During our testing of HCF claim payments, we determined that claim submissions often represented services rendered beyond the time frame specified in the respective third-party service agreements.</p> <p>We recommend that CalPERS evaluate whether the claim submission time frames established in the service agreements are reasonable based on the current operating environment. Service agreements should be enforced or revised accordingly. We further recommend that management, with the assistance of the service providers, determine whether procedures can be enhanced to improve the timeliness of claim submissions. Timely claim submissions are essential for CalPERS to manage its cash flows and ensure compliance with the service agreements.</p>	

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Management's Response:

IN PROGRESS. The Health Benefits Branch has evaluated the claim submission time frames established in the service agreements and believes they are reasonable based on current operating environment. The audit findings included claims that fell within exception rules in the claims system. The contract language is being amended and upon approval and completion will be provided to close this finding. The target completion date is November 30, 2010.

Observation 4: Real Estate Appraisals

Division responsible: Investment Office

Observation:

Properties held in separate account real estate partnerships are valued based on third-party appraisals directed by CalPERS. Appraised values are adjusted by the general partner to reflect changes in fair value between the appraisal date and the end of CalPERS' financial reporting period. CalPERS' real estate Performance Monitoring Unit (PMU) is responsible for ensuring appraised property values are properly recorded by the partnerships in accordance with the CalPERS' Investment Policy for Real Estate Accounting. During our testing of real estate partnership investments, we noted the following:

- The PMU faces significant challenges in performing the task of verifying that appraised values are being properly reflected in the partnerships' financial statements in a timely manner as there were approximately 1,600 individual properties appraised in fiscal year 2008-09 and only one staff was assigned to perform this function.
- Certain general partners report to CalPERS at the aggregate or fund level rather than the individual property level. In some instances, it was difficult to verify that the appraised values were reflected by the partnerships as property-level financial information is not provided by all general partners.
- Appraisals are completed throughout the fiscal year; however there is no process in place to evaluate the changes in fair value from the appraisal date to CalPERS' fiscal year-end.

CalPERS should enhance the current processes by employing the following recommendations:

1. Assign the appropriate number of personnel to verify that appraised property values are recorded by the partnerships.
2. Require separate account general partners to provide financial information at the underlying property level to facilitate the appraisal verification process.
3. For separate account real estate partnerships that were not appraised as of CalPERS' fiscal year-end, review the partnerships' June 30 financial information to ensure significant changes in fair value are properly reflected in the partnerships' June 30 financial statements.

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Management's Response:

IN PROGRESS. The Investment Office (INVO) concurs with the MGO recommendations and will enhance the following current processes:

1. At this point, INVO has not requested additional positions to verify the appraised property values recorded by the partnerships in their quarterly financial statements. INVO will examine its current staffing to determine if positions could be redirected from other INVO functions to perform this role.
2. The new Automated Real Estate Information System (AREIS) will provide the structure for reporting the financial information at the underlying property level. CalPERS is currently in its final stage of implementation. Real Estate general partners should have the ability to report at the property level starting with the 2010-11 Fiscal Year.
3. The INVO, Operations, Performance and Technology Division has recently instituted a new process where they now value CalPERS interests (required by the Appraisal of CalPERS Interests Policy) no more than five (5) months prior to June 30 of every year. This allows for no appraisal value of CalPERS interests to be more than five months old when provided as part of the year end financials.

Target completion date is June 30, 2012.

Observation 5: Accounting and Reporting Unitized Investments

Division responsible: Fiscal Services

Observation:

We observed that internally pooled (unitized) investments are allocated to participating funds based on the net asset value (NAV) of the unitized portfolios. NAV is equivalent to the price per share of the internal pool and reflects the fair value of the underlying investments adjusted for related investment receivables and payables. Reporting unitized investments at NAV may result in the misclassification of investment fair values and the related investment receivables, payables, income and expenses transactions.

We recommend that Fiscal Services Division, Investment Accounting Unit, separately allocate the fair value of unitized investments, receivables and payables for financial reporting purposes. Each fund's share of the fair value of unitized investments should be reported as part of the appropriate asset class. The allocated receivables and payables should be reported within the respective asset and liability line items in the financial statements.

Management's Response:

COMPLETE. Pending final approval from Macias Gini & O'Connell. Fiscal Services received concurrence from Macias, Gini & O'Connell on Fiscal's position to work with State Street Bank to develop an automated process for FY 2010-11. The automated process will separately calculate the ownership percentages for PERF and affiliate funds and reconcile the pool owner activity with the investment fund activity at the general ledger level.

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Observation 6:	Evaluation of Accounting Issues and Unique Transactions
Division responsible:	Fiscal Services
<p>Observation: During our audit, we identified material loans and investment purchases associated with the Federal Reserve's Term Asset-Backed Security Loan Facilities (TALF) Program that were not properly recorded. Current accounting practices do not prescribe specific procedures to identify, research and document unique transactions and accounting issues. As a result, there were inefficiencies in the audit process and material adjustments to the financial statements.</p> <p>We recommend that Fiscal Services should work with other Divisions and Branches within CalPERS to establish a process for identifying and properly accounting for new or unique transactions. The process should include formal documentation of the issue, pertinent background information, relevant legal and/or accounting guidance and the conclusions reached. The documentation should be prepared by staff with sufficient experience and reviewed by appropriate management personnel. Formal documentation will reduce staff and audit inefficiencies and ensure that transactions are properly and consistently reported in the financial statements.</p> <p>Management's Response: IN PROGRESS. Fiscal Services informed attendees of the March Financial Reporting Committee meeting to be aware of the need to inform Fiscal Services of any unique financial activity or transactions. Fiscal Services is in the beginning stages of implementing a process to identify new accounting pronouncements and/or unique transactions. Target completion date is September 2010.</p>	
Observation 7:	Implementation of New Accounting and Financial Reporting Standards
Division responsible:	Fiscal Services
<p>Observation: The System is required to implement GASB Statement No. 51, <i>Accounting and Financial Reporting for Intangible Assets</i> and Statement No. 53, <i>Accounting and Financial Reporting for Derivative Instruments</i> for the fiscal year ended June 30, 2010.</p> <p>GASB Statement No. 51 defines intangible asset as an asset that lacks physical substance, is non-financial in nature, and has an initial useful life extending beyond a single reporting period. The standard requires that qualifying intangible assets such as computer software, be reported as capital assets, and provides specific guidance on recognizing internally generated computer software. Accounting for the costs associated with the Pension System Resumption (PSR) and other projects should be evaluated in accordance with GASB Statement No. 51, and CalPERS should establish policies for the capitalization and depreciation of intangible assets, as applicable.</p> <p>GASB Statement No. 53 provides guidance regarding the accounting and reporting of derivative instruments, including hedge transactions. Changes in the fair value of hedging derivative instruments will be reported as deferrals in the statement of plan net assets. Changes in the fair value of derivative instruments that do not meet the criteria for an effective hedge or are</p>	

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associated with investments that are already reported at fair value are recognized as investment income in the current period reporting. CalPERS will need to determine the nature and extent of derivative investments to properly apply the provisions of GASB Statement No. 53.

We recommend that CalPERS develop a work plan for the implementation of new accounting and financial reporting standards. An effective work plan should include the following essential elements:

- assign staff with sufficient experience to evaluate the new standards and determine the applicability to CalPERS,
- identify key personnel and data needed for the implementation,
- establish a timeline for the implementation,
- provide training to key personnel throughout CalPERS,
- apply the new standards to interim data,
- document the relevant provisions and the conclusions reached in a formal memorandum, and
- draft revisions to the financial statements for management's and the external auditor's review.

Management's Response:

IN PROGRESS. For GASB 51, Fiscal Services is working with ITSB regarding policy on internally generated intangible assets (computer software). Fiscal Services will continue to work on capitalization policy and procedures, including establishing capitalization thresholds.

For GASB 53, Fiscal Services is drafting the position memo for Macias, Gini & O'Connell, along with note disclosures. Fiscal Services will finalize the position memo and disclosure notes and meet with Macias, Gini, and O'Connell to discuss the position memo. Target completion date is September 2010.